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PLR 200911001 - Section 7871 - Indian Tribal Governments Treated as States for Certain Purposes

Department of the Treasury
Internal Revenue Service
Washington, DC 20224

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Legend

Issuer =
Borrower =
Tribe =
County =
State =
a =
Year 1 =
Year 2 =

Dear [redacted data]:

This letter is in response to the Issuer's request that the Borrower will be treated as a political subdivision of a state under §§ 7871(a)(4), 7871(c), and 7871(d) of the Internal Revenue Code of 1986. In support of its request, the Issuer set forth the facts and representations described below.

FACTS AND REPRESENTATIONS

The Issuer is an electrical district established by the governing body of County pursuant to State law and is a political subdivision of State.

The Tribe is recognized as an Indian tribal government in Rev. Proc. 2002-64, 2002-2 C.B. 717, which lists Indian tribal governments that are to be treated similarly to states for specified purposes under the Code. The Borrower is a political subdivision of the Tribe, recognized as such by the Internal Revenue Service in Rev. Proc. 84-36, 1984-1 C.B. 510. The Borrower was established in Year 1 to provide utility service to the population of the Tribe, including electrical service, on the Tribe's reservation (the "Reservation"). Tribal law authorizes the Borrower to furnish utility, generation, telecommunications and information services, on a nonprofit basis and at reasonable costs, to all areas of the Reservation, where such services are determined to be feasible and economical, in order to improve the health and welfare of the Tribal members.

The Borrower is governed by a board (the "Board") having a members each of which is appointed by a committee of the Tribal council. The Borrower's officers are selected by, and responsible to, the Board. The Board, after a public hearing, sets the rates for the electrical service on a non-profit basis. For this purpose, the Board understands this to mean that rates must be adequate to assure the continued financial integrity and self-sufficiency of the Borrower, rather than generating a financial return to the Tribe. The Borrower has intermittently generated some net surpluses which have been used to fund necessary reserves, pay for capital improvements, and subsidize other utility operations, such as water and sewage services, by the Borrower. To date, the Borrower has not distributed any surpluses to the Tribe.

The Project is a gas-fired, combustion turbine electric generating facility and related support facilities located in County, State. The Issuer intends to issue bonds (the "Bonds") to finance a portion of the costs of the Project. The Borrower will enter into a set of long-term agreements (collectively referred to as the "Contract") with the Issuer under which the Borrower will acquire an undivided ownership interest in the Project and will pay its pro-rata share of the principal and interest on the Bonds for as long as they are outstanding. Borrower will file a Form 8038 with respect to the Contract. The Project is expected to be placed in service in Year 2.

Currently, the Borrower provides electric service to most of the Reservation. Other power providers generally may serve customers located on the Reservation only with permission of the Borrower in areas not served by the Borrower or in certain limited circumstances generally not subject to expansion. The Borrower owns no generation resources and must acquire at

wholesale all of the power to serve its customers. The Borrower provides a small amount of service to residential, public entity, and commercial customers immediately outside the Reservation where there is no comparable electric service available.

Approximately one third of the Borrower's electric power sales are to industrial customers, with the remainder a mix of residential, governmental, and commercial users. With some exceptions, the Borrower provides service to all its customers at standard rates and tariffs, including year-long supply contracts with large users.

To the extent that the Borrower expects to provide power from the Project to any user in a manner that causes private business use of the Project, any such private business use of the Project in excess of that permissible under § 141 will be financed with funding sources other than proceeds of the Bonds.

The Issuer presented evidence that in 2005 there were numerous governmentally owned electrical utilities ("municipal power utilities") serving 14% of residential customers in the United States and providing 15% of all power sold to ultimate consumers in the country. Approximately one third of the municipal power utilities will be 100 years old by 2010. The total original principal amount of currently outstanding bonds used to finance municipal power projects is approximately \$303 billion.

The Borrower fits within a group of 152 municipal power utilities with more than 20,000 customers. Forty-four percent of municipal power utilities in the Borrower's class (20,000 to 50,000 customers) have appointed governing bodies and 91% of such utilities in the Borrower's class serve some customers outside of their jurisdictional boundaries.

LAW AND ANALYSIS

Section 7871 sets forth the various purposes for which an Indian tribal government may be treated as a state. The term Indian tribal government is defined under § 7701(a)(4) of the Code to mean the governing body of any tribe, band, community, village or group of Indians, or (if applicable) Alaska Natives that is determined by the Secretary of the Treasury, after consultation with the Secretary of the Interior, to exercise governmental functions. The Secretary of the Treasury's determination is set forth in Rev. Proc. 200264, which contains a modified and supplemented list of Indian tribal governments that are to be treated similarly to states for specified purposes under the Code.

Section 7871(a)(4) provides that, subject to § 7871(c), an Indian tribal government shall be treated as a state for purposes of § 103 (relating to state and local bonds). Section 7871(c)(1) states that § 103(a) shall apply to an obligation (not described in § 7871(c)(2)) issued by an Indian tribal government (or a subdivision thereof) only if the obligation is part of an issue substantially all of the proceeds of which are used in the exercise of any essential governmental function. Section 7871(e) provides that an essential governmental function does not include any function that is not customarily performed by state and local governments with general taxing powers.

Section 7871(d) provides that for purposes of § 7871(a), a subdivision of an Indian tribal government shall be treated as a political subdivision of a state if (and only if) the secretary of the Treasury determines (after consultation with the secretary of the Interior) that such subdivision has been delegated the right to exercise one or more of the substantial governmental functions of the Indian tribal government. The Secretary of the Treasury's determination is set forth in Rev. Proc. 84-36, which contains a list of subdivisions of Indian tribal governments that are to be treated as political subdivisions of states for specified purposes under the Code.

Under § 7871(a)(4) and § 7871(c), an Indian tribal government may be treated as a State or political subdivision of a State for purposes of § 103(a) with respect to proceeds of an obligation issued by the tribal government if the proceeds of the obligation are used in the exercise of an essential governmental function within the meaning of § 7871(e). In the instant case, the Contract, entered into by the Borrower, will constitute an obligation for Federal tax purposes. Thus, if the proceeds of the Contract (i.e., the undivided interest in the Project to be owned by the Borrower) are used in the exercise of an essential governmental function, Borrower will be treated as a political subdivision of a state for purposes of § 103. Whether the ownership and use by the Borrower of its interest in the Project is an essential governmental function depends, in part, on whether such activity is customarily performed by state and local governments with general taxing powers.

Section 7871(c)(1) does not define the term essential governmental function, however, § 7871(e) limits the term to functions that are customarily performed by state or local governments with general taxing powers. In the absence of a definition, we turn to the legislative history of § 7871 to determine the intent of Congress with respect to tax exempt financing by Indian tribal governments.

The essential governmental function limitation has been in place since the original enactment of § 7871 by The Indian Tribal Government Tax Status Act, Pub. L. No. 97473, § 202 (1983) (the "1982 Act"). The Report of the Senate Finance Committee, explains:

The bill provides that Indian tribal governments are to be treated generally the same as states (and tribal subdivisions are to be treated generally the same as political subdivisions of states) for purposes of the tax-exempt bond interest provisions. However, the bill includes a number of restrictions on this treatment of Indian tribal governments with respect to commercial or industrial activities or other activities other than essential governmental functions. The purpose of those restrictions is generally either (1) to allow the profits from such activities to be exempt from federal income tax (because of the basic federal income tax exemption of Indian tribes and because Section 115 does not apply to Indian tribes) or (2) to allow the interest on the obligations where the proceeds are used in such commercial or industrial activities to be exempt from federal income tax, but not to allow both of these benefits to apply in any one case.

If all or a major portion of the proceeds of an Indian tribal government obligations are to be used, directly, or indirectly, in one or more commercial or industrial activities (or other activities other than essential governmental functions) conducted by the tribe then the interest on the obligation is not to be exempt from federal income tax.

S. Rep. No. 97-646, at 13-14 (1982).

The Senate Finance Committee report continues:

The bill permits one exception to this rule - where an Indian tribal government (or a subdivision of that government) issues an

obligation the proceeds of which are to be used in a utility-type activity. The bill provides that this exception applies only if the activity provides substantially all of its service on that tribe's reservation.

A utility-type activity includes the furnishing or sale of electrical energy, gas, water, or sewage disposal services. It does not include air or water pollution control facilities unless they are a part of the normal operation of what would otherwise be a utility-type activity. *Id.* at 14.

The Conference Committee followed the Senate amendment, with some modifications. The exception that would have allowed tribes to issue tax-exempt bonds for utility-type activities on the reservation disappeared as an exception. The Committee, however, specifically recognized sewers, a utility-type activity, as an example of an essential governmental function along with schools and streets. The Conference Report accompanying the 1982 Act states:

The conference agreement follows the Senate amendment, with modifications and clarifications. First, Indian tribal governments are permitted only to issue public activity bonds, the proceeds of which are used in an essential governmental function (such as schools, streets, and sewers). Therefore, tribal governments are not permitted to issue private activity bonds (i.e., industrial development bonds, scholarship bonds, and mortgage subsidy bonds).

H.R. Rep. 97-984 at 16-17 (1982)(Conf. Rep.).

We do not believe the exclusion of the specific exception for utility-type activity from the Conference Committee's report reflects an intent by Congress that utility-type activities may not be financed with tax-exempt bonds. We believe, instead, that the Conference Committee's specific inclusion of sewers as an example of an essential governmental function was indicative of its intent that engaging in utility-type activities, under appropriate circumstances, may constitute an essential governmental function.

In October of 1987, the House of Representatives, added § 7871(e) as part of The Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, § 10632(a)(1987)(the "1987 Act"). The House Report explains this provision as follows:

The bill clarifies that, with respect to bonds issued by Indian tribal governments, the term essential governmental function does not include any governmental function that is not customarily performed (and financed with governmental tax-exempt bonds) by States and local governments with general taxing powers. For example, the issuance of bonds to finance commercial or industrial facilities (e.g., private rental housing, cement factories, or mirror factories) which bonds technically may not be private activity bonds is not included within the scope of the essential governmental exception.

Additionally, the committee wishes to stress that only those activities that are customarily financed with governmental bonds (e.g., schools, roads, governmental buildings, etc.) are intended to be within the scope of this exception, notwithstanding that isolated instances of a State or local government issuing bonds for another activity may occur. Further, the fact that the Bureau of Indian Affairs may provide Federal assistance for Indian tribal governments to engage in commercial and industrial ventures as tribal government activities is not intended to be determinative for purposes of the Internal Revenue Code. (Any existing Treasury Department regulations that may infer a contrary result are to be treated as invalid.)

H.R. Rep. No. 100-391, at 1139 (1987).

The Conference Report to the 1987 Act provides:

The Conference agreement follows the House bill with a modification permitting Indian tribal governments to issue as tax-exempt private activity bonds certain bonds for tribal manufacturing facilities as an exception to the general rule that tribal governments may issue tax-exempt bonds only for essential governmental functions which States and local governments customarily perform. The conferees adopted this limited exception in recognition of the unique responsibilities of Indian tribal governments in managing historical tribal resources and land held in trust by the Federal Government and limited its scope to bonds designed to foster employment opportunities on these tribal lands as part of the performance of this unique responsibility.

H.R. Rep. No. 100-495, at 1012 (1987)(Conf. Rep.)(footnote omitted).

Under the specific language of § 7871(e), an activity must be customarily performed by State and local governments to be eligible to be an essential governmental function. The term customary has been defined as "agreeing with custom; established by custom; commonly practiced, used, or observed; familiar through long use or acquaintance." In applying this definition to § 7871(e), we look both to the prevalence of such activity among state and local governments as well as the history of state and local governments performing the specific activity. This approach is consistent with the legislative history of § 7871(e), which says that to find that something is customarily performed requires more than "isolated instances" of comparable activity.

Finally, the 1987 House Report and the 1987 Conference Report indicate that Congress viewed activities customarily conducted by state and local governments as including public works style projects and excluding commercial and industrial activities such as manufacturing facilities. Congress further reflected this understanding by creating a special exception to the private activity bond rules for certain tribally owned manufacturing facilities.

Thus, based upon the language of the statute, the legislative history of § 7871(a)(4) in general and § 7871(e) in particular, we conclude that an activity is to be considered an essential governmental function customarily performed by state and local governments only if: (1) there are numerous state and local governments with general taxing powers that have been conducting the activity and financing it with tax-exempt governmental bonds, (2) state and local governments with general taxing powers have been conducting the activity and financing it with tax-exempt governmental bonds for many years, and (3) the activity is not a commercial or industrial activity. For purposes of applying this analysis where the activity is the ownership and operation of a facility, only comparable facilities owned and operated by states and local governments may be taken into account.

Based on the above information, we find that the ownership, operation, and financing with proceeds of tax-exempt bonds of the facilities of municipal power utilities to be both sufficiently prevalent and sufficiently longstanding among state and local governments to be considered customarily performed by state and local governments. The Borrower's electrical utility system, including its proposed interest in Project, is comparable to the generation, transmission, and distribution systems of these

prevalent and longstanding municipal power utilities. Accordingly, we find that the Project is comparable to schools, roads, and sewers customarily owned and operated by state and local governments.

Once we conclude that the ownership and operation of Borrower's interest in the Project is an exercise of a governmental function that has been performed for many years by numerous state and local governments, we need to also determine whether ownership and operation of that interest is a commercial or industrial activity. The legislative history to § 7871 does not define the criteria for identifying a commercial or industrial facility but it does state that "commercial or industrial facilities (e.g., private rental housing, cement factories, or mirror factories) . . . [are] not included within the scope of the essential governmental function exception." H.R. Rep. No. 100-391, at 1139 (1987).

The legislative history of § 7871 indicates Congress was making a distinction between a broader public interest and an interest in profit when it distinguished an essential governmental function from a commercial or industrial activity. Similarly, the purposes of an organization exempt under § 501(c)(3), which must serve a broad public interest, cannot include commercial purposes that serve the private interest of those who profit.

As courts have done for purposes of determining the commercial nature of an entity under § 501, we look to all the facts and circumstances to determine whether the ownership and operation of Borrower's interest in the Project is commercial or industrial in nature for purposes of § 7871(c) and (e). Relevant factors include, but are not limited to whether the Borrower operates that interest (a) to earn a profit for the Tribe, (b) in competition with for-profit entities, and (c) in a commercial manner. We also look at the balance of the operations of the Borrower with respect to its interest in the Project between service to the local community and to paying customers outside of the local community.

Although Borrower provides services similar to those of investor-owned electrical utilities, unlike those businesses, Tribal law requires that Borrower as an entity operate on a non-profit basis. Hence, the rates set for the delivery of electrical service, including those derived from its interest in Project, are to be set high enough for self-sufficiency, but not to earn a profit for the Tribe. Consistent thereto, surpluses, when generated, are not paid to the Tribe, but are used by the Borrower to fund necessary reserves, make capital improvements and subsidize other utility services within the Borrower's service area. With very limited exceptions, Borrower, in an uncompetitive environment, delivers electrical power only to residential, commercial, and industrial customers within the Reservation. The presence of these factors indicates that Borrower's ownership and operation of the Project is not a commercial activity, and is indistinguishable from public works projects such as roads, schools, sewers, or governmental buildings which lack a profit-making objective, focus on public benefits to local citizens, and are not in competition with other businesses.

With respect to the balance of the operations of the facility between service to the local community and to paying customers outside of the local community, the electrical power generated by Borrower's interest in the Project will be used to service the local population with only minimal amount of power sold to customers in the immediate vicinity of the Reservation that are not adequately served by other power providers.

CONCLUSION

Accordingly, we conclude that the ownership and operation of the Borrower's interest in Project will be an exercise of an essential governmental function customarily performed by state and local governments within the meaning of § 7871(c) & (e). Consequently, Borrower will be treated as a political subdivision of a state for purposes of applying §§ 103 and 141 to the Bonds.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter, including whether the Bonds are tax-exempt under § 103 of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 11.04 of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 50. However, when the criteria in section 11.06 of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 51 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Timothy L. Jones
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